Memo

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To Files
From David D. Duncan
Debra A. Cash
Date October 15, 2001
Subject Enron-Raptor Entity Note Impairment

Overall Background

The Raptor entities are a series of SPE's (LLP's in form) set up for the purpose of hedging certain merchant investments where Enron perceived it had significant exposure to volatility. In early September, 2001, Enron brought to our attention that it believed there might be a fairly significant impairment of certain notes it had with the Raptor entities. In addition, Enron informed us that they were considering approaching the Raptor counterparties to negotiate to settle out of the entities because of changes in their top management and their desire to extract themselves from various structured activity which has been perceived negatively by the analyst community. As a result of this impending and potentially significant reporting event, combined with the complexity and sensitivity of the related party disclosures associated with the Raptor transactions, we undertook to review our collective accounting advice related to these vehicles with the Professional Standards Group (PSG) and others in practice and risk management.

Reference is made to memos dated March 28, 2000 (Raptor Transaction), July 31, 2000 (Raptor II Transaction), November 9, 2000 (Raptor III Transaction), as amended, October 12, 2001, and December 27, 2000 (Raptor IV Transactions) for background on the "Raptor Entities". Reference is also made to the memos dated December 28, 2000, May 9, 2001 and August 31, 2001 for various Raptor transaction updates.

We confirmed our prior positions, as described in the memos. However, in connection with our review, the PSG reiterated to us that they did not view the use of the aggregated impairment test methodology that had been adopted by the client, and with which we had concurred, to be an acceptable impairment test methodology. The remainder of this memorandum discusses our prior and current deliberations with respect to this issue.

Background Regarding Impairment Discussions

Currently Enron has approximately $2.3 billion of notes receivable from the Raptor entities. The notes are consideration received by Enron for 1) prior sales of Enron restricted stock and stock rights and 2) the settlement of net amounts due from the Raptor entities related to various derivative instruments. The notes bear interest at 7% with interest and principal due in April 2005, when the Raptor entities are scheduled to automatically liquidate.

Enron also has approximately $500 million, $780 million and $780 million of price risk management assets related to derivatives with the Raptor entities at December 31, 2000, March 31, 2001 and June 30, 2001, respectively. The instruments meet the definition of SFAS 133 "Accounting for Derivative Instruments and Hedging Activities" and are reported on Enron's books at fair value.

In addition to the notes and derivatives, at the time of the formation of each of the Raptor vehicles, Enron purchased, for nominal consideration, a non-voting member interest in each vehicle which gave Enron the rights to any residual value available, upon liquidation of the vehicles, after achievement of a certain stated return for the outside equity investors.

Beginning in late 2000, but more precipitously in the first quarter of 2001, many of the financial instruments in the Raptor entities declined in value. In connection with our ongoing monitoring of these entities, we have had numerous discussions with management regarding how to determine when an impairment of the Raptor related derivatives and notes receivable may be appropriate.

In our analysis of the notes, we determined that they do not represent a share, participation or interest in the underlying assets of the entities. Although, the only transactions that the Raptor entities have are with Enron, and Enron can only look to the underlying assets within Raptor for credit purposes, the form of the notes are not debt securities as defined under SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities." Accordingly, Enron management determined that SFAS No. 114 was the appropriate authoritative guidance for determining impairment with respect to the notes and we concurred. SFAS No. 114 states, "a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. The term "probable" as used in SFAS No. 114, is consistent with its use in Statement 5, which defines probable as an area within a range of the likelihood that a future event or events will occur confirming the fact of loss." Probable is the area within that range where such future events are likely (vs. reasonably possible) to occur.

SFAS No. 114 goes on to state that "measuring impaired loans requires judgement and estimates... creditors should have latitude to develop measurement methods that are practical in their circumstances". "A creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that, as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable".

Considering the guidance in SFAS 114, Enron proposed an approach to evaluate the collectibility of the Raptor notes using Monte Carlo and other simulation methods that would reflect Enron's view that declines in value could recover over the holding period of the notes. Enron noted that many of the financial instruments underlying the notes had exhibited, and would be expected to continue to exhibit, a high degree of volatility. Since the notes were not scheduled to be repaid for a number of years, Enron's position was that SFAS 114 gave Enron the flexibility to estimate what it thought was a likely outcome considering this time horizon.

As we considered Enron's proposed approach through the second quarter, we noted that SFAS 114 does give a creditor a choice of measurement alternatives, as described above, and does not dictate one approach over another (unless the notes are collateral dependent and it is determined that foreclosure is probable, which it was not in this situation). Accordingly, we could not disagree that SFAS 114 allowed for subjectivity with regard to expected future outcomes and that simulation methods were appropriate methods for determining the likelihood of possible future value outcomes. Notwithstanding that view, we informed Enron that our preference, as an indicator of potential impairment, would be for a more objective evaluation approach using the loans underlying collateral value with that collateral value limited to the publicly traded price of the underlying securities, where available, because:

1. We believed the publicly traded price of a security to be the best indicator of the value of that security and that such price embodies the markets broad view of all possible future events and methods of valuation;
2. We believed the publicly traded price to be the best "current information and events" as support for what Enron could expect will occur with respect to the recoverability of the notes from these vehicles; and
3. We believed that the objectivity provided by using the publicly traded price (vs. a company prepared simulation of potential future events) was important considering the structured nature of the vehicles.

An issue we considered was whether utilizing the screen price for the restricted Enron stock related instruments was appropriate (as opposed to a discounted value that might be appropriate if the current restrictions on these instruments were considered). We noted that foreclosure with respect to the notes was not indicated and that there was nothing to indicate, through the second quarter that the notes would be settled prior to their scheduled liquidation. We noted that the restrictions naturally expire at or before the scheduled liquidation and that the ultimate collateral would be unrestricted shares. We determined that it was appropriate to consider this contractual event that will occur, that is the expiration of the restrictions, in assessing the probability of collection on the notes given those facts and circumstances. We informed Enron that, if those facts and circumstances changed, whereby 1) foreclosure became imminent or 2) there was an intention to settle the Enron stock related instruments prior to the lapse of the discount and their scheduled liquidation, the impairment test should then only consider the current settlement value of the restricted securities (which we would expect would be an amount less than screen).

Considering our views, Enron proposed to limit its views of recovery to the value of the underlying collateral securities in the vehicle using current publicly trade prices, but to perform their impairment assessment on an aggregate (of all of its interests in all of the vehicles) basis, rather than on an entity-by-entity basis, beginning in the first quarter of 2001. In connection with the development of this alternative, Enron negotiated an agreement in March 2001 with the Raptor entities that 1) assigned each Enron entities' rights to receive any distributions from these instruments in any of the respective Raptor entities to other Raptor entities, to the extent such entities have obligations due to an Enron entity that cannot be fully paid by the Raptor entity, 2) restricted Enron's ability to sell any portion of its rights to interests in any Raptor entity prior to the liquidation date and 3) realigned the various liquidation dates of the Raptor entities, previously in different months and years, to all occur simultaneously (April 2005). The effect of the assignment was that Enron committed to forego its rights to its member interest in Raptor entities where such interest may have value for the benefit of other Raptor entities that could not fulfill their obligations to Enron at liquidation.

Enron's position was that, while the March 2001 agreement was not required, it would help address our concerns of subjectivity (by lending some discipline and objectivity to the overall assessment) and noted that it would never yield a result more favorable than the net amounts recoverable from the entities if all positions (that is, Enron's notes receivable from the Raptor entities, price risk management asset related to the Raptor entities, and Enron's member interests in the Raptor entities) were liquidated as scheduled (as indicated by current prices). Also, although Enron had always viewed these exposures in the aggregate from a practical standpoint, they believed that the change they implemented with the March 2001 agreement gave important legal form (in terms of the order of liquidation) to that position and lent support to their alternative approach.

As we considered the acceptability of Enron's conclusion, we made the following observations:

- SFAS 114 1) does not dictate a methodology for estimating future cash flows for purposes of determining impairment unless foreclosure is probable, 2) recognizes that expected cash flows are "usually uncertain" and that a "creditor will be required to exercise significant judgement in developing the estimates of future cash flows", and 3) states that "creditors should have latitude to develop measurement methods that are practical in the circumstances". The net result of this was our view that SFAS 114 allowed for subjectivity.

- In other areas of authoritative literature where impairment is based on fair value, we noted that the overriding concept was for declines that are "other than temporary". The AICPA Audit and Accounting Guide related to Auditing Derivative Instruments, Hedging Activities, and Investments in Securities states in part in paragraph 47... "Regardless of the valuation method used, generally accepted accounting principles might require recognizing in earnings an impairment loss for a decline in fair value that is other than temporary. Determinations of whether losses are other than temporary often involve estimating the outcome of future events. Accordingly, judgment is required in determining whether factors exist that indicate that an impairment loss has been incurred at the end of the reporting period. These judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about future events. The following are examples of such factors that may indicate an impairment.

    - Fair value is significantly below cost and -
        - The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
        - The decline has existed for an extended period of time.
        - Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

    (Remainder of paragraph not included)

  We noted that, although SFAS 114 does not require a fair value approach (unless foreclosure is probable) and is therefore possibly more subjective than this concept, that considering this concept in our facts and circumstances might help us determine reasonable limits to the subjectivity we might accept. We noted that the recent declines in the value of the various underlying financial instruments which might indicate impairment had been rapid and precipitous and many of these financial instruments had demonstrated a great deal of volatility. We further noted that Enron had the ability to hold the securities (notes) for a period over which they might recover.

- The Raptor entities and related exposures are very unique and complex. As structured transactions they are very form driven. The client's view was that the form of the assignment they used in their alternate "aggregation" methodology was important. Although, we were concerned that the assignment was not substantive since it did not appear to, other than the realignment of the settlement dates, impact anyone but Enron (and we were aware

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that this was the view of individuals in the PSG based on prior discussions about the use of various forms of cross-collateralization considered by Enron prior to yearend), we had to acknowledge that Enron had indeed contracted with the Raptor entities to legally change the form of ultimate settlement. In addition, Enron's methodology satisfied one of our major concerns in that it institutionalized an impairment test using current market values without reliance on more subjective matters of judgement as to future performance and volatility of the underlying assets of the Raptor vehicles.

Considering all of the above factors, particularly the fact that 1) any indicated impairment, greater than that already contemplated by Enron's methodology, resulted from declines of volatile instruments which made a temporary decline position under these facts and circumstances and 2) the net result of Enron's methodology was to impair the notes in the aggregate to the extent that currently indicated recoverable values of all positions demonstrated a net economic loss during first quarter 2001, we determined Enron's methodology was reasonable. At the time this conclusion was reached, the engagement team realized that Enron had not achieved true cross-collateralization as was recommended by our PSG as early as December, 2000 to permit an aggregate test. However, we believed that the issue was an audit issue and given the latitude allowed under SFAS 114 necessitated that we discuss our conclusions with the Practice Director and Concurring Partner.

In late March 2000, we discussed our conclusions with Mike Odom, Practice Director, and Mike Lowther, Concurring Partner, who concurred.

Recent Discussions

In the third quarter, we began to review all of our prior conclusions and advice related to the vehicles. In connection with this review, the PSG continued to express concerns with respect to the client's use of the aggregated impairment test methodology not withstanding our other considerations. In the PSG's view, the cross assignment should not be given accounting recognition because it is an agreement between related parties that has no economic consequence to Enron or to any other entity. As such it appears to be a nonsubstantive agreement with no apparent purpose other than to achieve a financial reporting objective.

While we had believed that the approach adopted by the client was practical in the circumstances for all of the reasons previously mentioned, we 1) informed Enron management that we now viewed their use of the aggregated impairment test methodology to be incorrect and 2) began a more detailed review of the vehicles on an entity-by-entity basis to determine whether we believed an impairment would be required in any prior periods considering alternative methods.

Enron continued to believe their methodology to be reasonable. However, they also did not believe that any additional impairment would be warranted at the end of the first or second quarter if other alternative methods were considered. They again pointed out that SFAS 114 does not prescribe that a term loan is required to be marked to the current market value of the underlying collateral unless foreclosure is probable. As has been previously discussed, our reading of SFAS 114 supported this view. Enron also pointed out:

1. The investments in the Raptor vehicles have a history of high volatility and,

2. for the most part, the underlying investments in the under-water vehicles were in operating entities with prospects for recovery. Enron believed that simulation models applied to all of the underlying investments of the Raptor entities would indicate that no impairment was required at the end of any of the previous reporting periods.

Attachment I is a summary of the results of an entity-by-entity review of the Raptor vehicles. Based on that review we determined that only Raptor I, III and IV required further analysis using an alternative approach. The alternative approach, which we discussed with the PSG, was as follows:

Step 1. Quarterly, determine on an entity by entity basis, whether there is an indication of a possible impairment. An indication of a possible impairment would be if thenet fair value of all the financial instruments of an entity, using screen prices at the date of evaluation, is less than the recorded amount of the notes and price risk management assets on Enron's balance sheet with that same entity. If the fair value exceeds the note and price risk management assets balance on Enron's books, no further analysis for impairment is necessary for the period. If the total fair value of the assets is less than the notes on Enron's books with that entity, further analysis is warranted to determine if the notes have been impaired.

Step 2 (step 2 is performed only if a possible impairment is indicated by step 1) Additional analysis consists of reviewing the individual underlying financial instruments held by the entity to determine if any have been other than temporarily impaired. An other than temporary impairment would be indicated if a security's stock price has been below its original stock price (when entity acquired the stock) for more than 6 months, if a company has gone bankrupt or is having severe financial difficulties. If the securities stock price has been below its original price for more than 6 months, but there are other indicators that may lead you to believe that the security is not other than temporarily impaired, they may be considered. Examples of a few indicators, other than stock price that may be considered are declines in the general stock market or industry category relative to the company, improving operating results, positive cash flow, and that the company appears to be successfully executing it's business strategy. These indicators may lead you to believe that there is not an other than temporary impairment even through the securities stock price has been down for more than 6 months. If an other than temporary impairment is indicated, the underlying security is impaired to the then public price. If there is not an other than temporary impairment indicated, then the security can be valued using a monte carlo simulation methodology to determine, with a minimum 25% confidence level, what the security price would be upon settlement of the underlying instrument or security. Monte Carlo simulation methods are used to predict possible outcomes of security prices at some date in the future based on current security prices and past volatility given certain confidence levels. A 25% confidence level was used to demonstrate that it was possible for the security to meet or exceed the indicated outcome from the Monte Carlo simulation. An impairment would be necessary if it is probable that you will not collect. If the sum of the current market price for the other than temporarily impaired financial instruments and the Monte Carlo values for the temporarily impaired financial instruments would provide sufficient value to pay the notes to Enron at the scheduled maturity of the notes, it is not probable that the notes are impaired.

Step 3 (step 3 is performed if step 2 results in a conclusion that the notes are impaired) The notes are written down to the current screen price of the underlying financial instruments held by the specific Raptor entity.
We reviewed the client's analysis using this alternative, and concurred with the Company's conclusion that no

impairments would have needed to be recorded on the notes with Raptor entities at December 31, 2000, March 31, 2001 and June 30, 2001. See attachments I, A1, A2 and A3 that support our conclusions.

We discussed our conclusions with those listed below, who concurred.

Steve Goddard	Larry Reiger	John Stewart
Bill Swanson	John Geron	Rick Petersen
Mike Odom	Gary Goolsby	Ben Neuhausen
Mike Lowther	Rich Corgel	Amy Ripepi